

1 **DIRECT TESTIMONY OF**
2 **THOMAS R. OSBORNE**
3 **ON BEHALF OF**
4 **SOUTH CAROLINA ELECTRIC AND GAS COMPANY**
5 **DOCKET NO. 2002-223-E**
6
7

8 **Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS**
9 **ADDRESS.**

10 A. My name is Thomas R. Osborne. I am a Managing Director in the Global
11 Energy and Power Group within UBS Warburg LLC's Investment Banking
12 Department. My business address is UBS Warburg LLC, 299 Park Avenue, New
13 York, NY 10171.

14
15 **Q. MR. OSBORNE PLEASE STATE YOUR EDUCATIONAL**
16 **BACKGROUND.**

17 A. I hold a Bachelor of Arts degree, with distinction, from the University of
18 Virginia, where I was elected to Phi Beta Kappa.

19
20 **Q. WHAT IS YOUR BUSINESS BACKGROUND?**

21 A. As a Managing Director within the Global Energy and Power Group at
22 UBS Warburg, I am primarily responsible for investment banking coverage of

1 regulated electric, gas and water utility companies, independent power producers
2 and related power industry participants. I joined UBS Warburg in May 2001 after
3 spending five years as a Director in the Global Energy Group at Credit Suisse First
4 Boston. Prior to joining Credit Suisse First Boston, I spent nine years (1987-1996)
5 in the Utility Investment Banking Group at PaineWebber Incorporated, holding
6 the titles of analyst, associate, vice president and first vice president. During my
7 fifteen years of investment banking experience, I have worked on transactions
8 with an aggregate value in excess of US\$30 billion. I have extensive experience
9 with corporate utility issuers in the equity and fixed income capital markets, and I
10 have advised utilities on numerous mergers and acquisitions ("M&A") and
11 generation asset divestitures, as well as restructurings. In recent years I led the
12 financial advisory team for the proposed divestiture of 3,000 megawatts of electric
13 generation assets by Sierra Pacific Resources and advised Pinnacle West Capital
14 Corp. in a proposed generation asset swap and generation company restructuring.
15 Other transactions for which I have acted as an advisor include: the leveraged
16 recapitalization of DPL Inc. including an investment by Kohlberg, Kravis, and
17 Roberts, the TXU gas processing divestiture, the PG&E Australian Pipeline
18 divestiture, Northeast Utilities' acquisition of Yankee Energy System, Iowa-
19 Illinois Gas and Electric's merger with Midwest Resources, Midwest Energy's
20 merger with Iowa Resources and GTE's acquisition of Contel.

1 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY BEFORE THE**
2 **PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA?**

3 A. Yes, although the case was subsequently withdrawn.

4
5 **Q. ON WHAT DATE AND IN WHAT CAPACITY WAS YOUR TESTIMONY**
6 **PROVIDED?**

7 A. In January 2002, in Docket No. 01-220-6, I provided testimony on behalf of
8 South Carolina Pipeline Corporation with respect to identifying a group of
9 publicly traded companies that faced similar business and financial risks to those
10 of the applicant.

11
12 **Q. HAVE YOU SUBMITTED TESTIMONY BEFORE OTHER**
13 **REGULATORY BODIES?**

14 A. Yes. I have previously testified before the Public Utilities Commission of
15 the State of Nevada.

1 **Q. MR. OSBORNE, PLEASE DESCRIBE THE PURPOSE OF YOUR**
2 **TESTIMONY IN THIS PROCEEDING.**

3 A. South Carolina Electric and Gas (“SCE&G” or the “Company”) has
4 requested my expert opinion in identifying publicly traded companies (the “Peer
5 Group”) that face business and financial risks comparable to those of SCE&G.
6 The Peer Group is included as Exhibit Nos. __ (TRO-1, 2 and 3), which is
7 attached to this testimony.

8
9 **Q. PLEASE DISCUSS THE BUSINESS AND FINANCIAL RISKS FACED BY**
10 **SCE&G AND THE COMPARABLE COMPANIES.**

11 A. As part of my selection of companies for the Peer Group, I gave careful
12 consideration to companies with business and financial risks similar to those of
13 SCE&G.

14 As primarily regulated utilities, SCE&G and the Peer Group collectively
15 are exposed to similar business risks which include, among other factors,
16 regulatory and legislative actions including rate setting, deregulation and the
17 imposition of environmental controls legislation; fluctuating power demand
18 resulting from a variable macroeconomic environment and/or weather conditions;
19 customer and/or asset concentration; limited ability to alter the generating fuel
20 source in the case of electric utilities; commodity price volatility and fuel supply

1 risk. These risk factors have the potential to materially affect a company's ability
2 to effectively and profitably execute its strategic plan by causing, among other
3 things, higher levels of competition, which could lead to a lower market share
4 and/or a higher risk customer mix; loss of competitive position within the
5 respective service area; increased levels of counterparty risk; increased risk of
6 default on debt obligations or on energy contracts and the resulting operating
7 effects of the inability to execute such transactions; and/or increased exposure to
8 commodity price volatility and other macroeconomic risks. These business risks
9 are captured in metrics such as asset concentration, relative cost competitiveness,
10 the percentage contribution of assets from unregulated businesses, Standard and
11 Poor's business position ranking, fuel supply concentration and customer
12 segmentation.

13 In my analysis and selection of the Peer Group, I have also focused on
14 financial metrics which provide information on SCE&G's risk-return profile. As
15 with the business risks, SCE&G and the Peer Group collectively are exposed to
16 similar financial risks which include, among other factors, the negative effects that
17 higher interest rates or restricted access to capital can have on capital intensive
18 businesses with high levels of financial leverage, adverse effects resulting from a
19 lack of financial flexibility, as well as a deterioration in cash flows and the
20 resulting ability to service debt and pay dividends. These risk factors have the
21 ability to adversely affect a company by increasing the cost of capital and/or

1 restricting access to the capital markets, reducing financial flexibility thus
2 increasing the cost of financial distress and/or likelihood of default, which could
3 materially affect management's ability to effectively and profitably execute its
4 strategic plan and which could thus negatively impact operating earnings. The
5 financial metrics selected to capture these risks include market capitalization,
6 financial leverage, interest coverage ratios, credit ratings, dividend yield and
7 implied valuation multiples, among others. The rationale for the selection of these
8 metrics was that they provide information and insight into determining a
9 company's risk-return profile as it relates to financial flexibility, quality of
10 earnings and stability of cash flows, sustainability of profit margins and ability to
11 access the capital markets.

12
13 **Q. PLEASE DISCUSS YOUR CONSIDERATIONS IN DETERMINING A**
14 **PEER GROUP FOR SCE&G.**

15 A. I have formulated my opinion based on fifteen years of financial industry
16 experience within the utility sector. As you are aware, SCE&G's operations are
17 primarily regulated electric and natural gas businesses. The Peer Group for
18 SCE&G was selected based on a comparison of several key operational and
19 financial metrics across a range of U.S. utility companies from various geographic
20 regions. Among the key metrics I considered are: total market capitalization,

1 capital structure, financial leverage, credit ratings, Standard and Poor's business
2 position ranking, the overall contribution of assets and operational flows from
3 regulated electric and regulated gas operations, the extent of investment in
4 unregulated businesses, and profitability.

5 The companies in the Peer Group were selected based upon their asset mix
6 being comprised principally of utility operations. I also considered the fact that
7 SCE&G serves approximately twice the number of electric customers as it does
8 natural gas customers and as such employs fixed assets which are weighted
9 towards the generation, transmission and distribution of electricity. Furthermore,
10 SCE&G's financial leverage, credit ratings and profitability, among other factors,
11 suggest that the company should be compared to a peer group with credit ratings
12 near the middle of the investment-grade spectrum. These were my primary
13 considerations when determining the appropriate subset of peers to select from the
14 universe of regulated U.S. electric and gas utilities.

15
16 **Q. COULD YOU PLEASE DESCRIBE THE FACTORS CURRENTLY**
17 **INFLUENCING INVESTORS' VIEWS OF ELECTRIC AND GAS**
18 **UTILITIES AS INVESTMENT VEHICLES?**

19 **A.** Based in part on the dramatic deterioration in the credit quality of some of
20 the leading industry participants, questions about corporate accounting practices

1 and the impact of proposed regulatory and legislative changes on the utility
2 operating environment, increased regulatory scrutiny, and actual or threatened
3 bankruptcies, the power industry is currently in a state of turmoil. As a result,
4 investors have taken an increasingly critical view of the power sector generally
5 and of those companies that are actively and substantially involved in unregulated
6 merchant energy activities. As has been the case in the broader equity market,
7 there has been a “flight to quality” in the power sector as investors are increasingly
8 being drawn to companies with credible business strategies, transparent
9 accounting and experienced, reputable management teams. Unfortunately, the
10 entire power sector, and not only those companies engaged in unregulated
11 merchant energy activities, is now being perceived by investors as entailing more
12 risk. Consequently, the power sector as a whole and each individual company
13 must provide sufficiently high returns to continue to attract investor capital.

14
15 **Q. WHAT IMPACT DOES THE REGULATOR HAVE ON THE PERCEIVED**
16 **RISK OF UTILITY SECURITIES?**

17 A. Capital is a limited financial resource that is allocated only to those entities
18 that meet the risk-return requirements of investors. This allocation of financial
19 resources occurs in the capital markets and as such, the actions of the state
20 regulatory commission are not only a matter of public policy, but also a matter of

1 financial policy as the attention of the financial markets is closely focused on how
2 policies, actions, and decisions of state regulators affect investors' expected
3 returns. The Commission and the Company have reason to give careful and
4 thoughtful consideration to the requirements of the capital markets, because they
5 are the mechanisms which price risk and allocate available capital to the users of
6 capital – corporations, individuals and governments. The Commission's actions on
7 matters such as cost recovery, balancing of customers' and shareholders' interests,
8 quality of service, deregulation, and authorized rates of return materially impact
9 valuation as a result of how adequately the company's expected return
10 compensates investors for their assumption of risk. Much to the credit of the
11 Commission and SCE&G, the Company has been a financially sound utility. The
12 Commission's continued support of SCE&G through its thoughtful and equitable
13 actions is imperative to engendering investor confidence and maintaining a stable
14 operating environment which, in turn, will allow SCE&G to more effectively
15 compete for the capital resources that it requires to provide reliable service at a
16 reasonable cost to its customers. Moreover, the Company's ability to earn
17 reasonable rates of return on its equity is the product of both fair and timely
18 regulatory treatment and positive financial and operating policies instituted by
19 management. Continuation of these policies over the coming years will be
20 critically important to investors in light of the increased competitive pressures and
21 the evolution that is currently underway in the power sector.

1 **Q. WHAT TYPE OF COMPANY WOULD YOU DEEM COMPARABLE FOR**
2 **PURPOSES OF CALCULATING SGE&G'S COST OF CAPITAL?**

3 A. I would consider an ideal comparable company to be a regulated generator,
4 transmitter and distributor of electricity and natural gas to a stable mix of
5 residential, industrial, and commercial customers. The company would have little
6 in the way of unregulated operations and direct commodity price risk but would
7 carry principally regulatory and operational risk. Lastly, the company would
8 operate in a state(s) which remain primarily regulated at the generation,
9 transmission and distribution levels. To this end, I believe the companies listed in
10 Exhibit Nos. ____ (TRO-1, 2 and 3) accurately reflect comparable companies for
11 SCE&G.

12
13 **Q. WHY DO YOU VIEW THE COMPARABLES YOU HAVE IDENTIFIED**
14 **AS APPROPRIATE?**

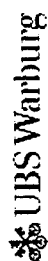
15 A. There are very few publicly traded companies that have the same business
16 model and business risk profile as SCE&G. For this reason, I have identified
17 companies from two categories: Integrated Utilities with both regulated electric
18 and regulated natural gas operations, as well as Electric Utilities, which based on
19 SCE&G's status as primarily an electric service provider, also provide a fair proxy
20 for the Company. Each of these companies was selected based on its overall

1 comparability and its exposure to business and financial risks similar to those of
2 SCE&G.

3 These companies are primarily regulated entities that have solid
4 investment-grade credit ratings, have a relatively modest proportion of unregulated
5 businesses, and have manageable exposure to commodity price volatility. These
6 companies are comparable to SCE&G in that they are similar in size and face
7 similar regulatory, operational, environmental, and general financial risk. I believe
8 the Peer Group is thus an appropriate set of comparable companies for evaluating
9 SCE&G's cost of equity capital.

10
11 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

12 **A. Yes.**



TOTAL RETURN ANALYSIS

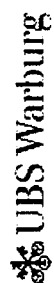
Company Name	Share Price ¹ (\$)	Shares Outstanding ² (mm)	Equity Market Value ¹ (\$mm)	Indicated Annual Dividend ² (\$)	Dividend Yield (%)	I/B/E/S Long-term EPS Growth ¹ (%)	FirstCall Long-term EPS Growth ¹ (%)	I/B/E/S Total Return (%)	FirstCall Total Return (%)
DPL Inc.	18.25	126,501	2,309	0.94	5.2	7.5	7.0	12.7	12.2
Energy East	20.36	116,832	2,379	0.96	4.7	6.8	6.0	11.5	10.7
Great Plains Energy	19.79	61,909	1,225	1.66	8.4	4.7	4.0	13.1	12.4
IDACORP, Inc.	25.32	37,612	952	1.86	7.3	8.0	8.0	15.3	15.3
NSTAR	42.25	53,033	2,241	2.12	5.0	6.4	7.0	11.4	12.0
Pinnacle West Capital Corporation	33.05	84,807	2,803	1.60	4.8	6.6	6.0	11.4	10.8
Vectren Corp	23.22	67,730	1,573	1.06	4.6	7.7	7.0	12.2	11.6
Mean					5.7	6.8	6.4	12.5	12.1
Median					5.0	6.8	7.0	12.2	12.0

SOURCE: Bloomberg, FactSet, FirstCall and SEC Filings

NOTES:

1. As of 08/01/02

2. As of 3/31/02



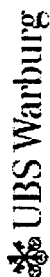
COMPARABLE TRADING ANALYSIS

Company Name	Symbol	Equity Market Value ¹ (\$mm)	Total Enterprise Value ¹ (\$mm)	Enterprise Value		Equity Market Value Multiples				I/B/E/S		FirstCall Long-term EPS Growth ³ (%)	Dividend Yield (%)
				Multiple LTM	Multiple EBITDA	2002E		2003E		Long-term EPS Growth ² (%)	Book Value (x)		
						EPS (x)	Value (x)	EPS (x)	Value (x)				
DPL Inc.	DPL	2,309	4,797	7.2	7.2	10.9	10.2	2.8	7.5	7.0	5.2		
Energy East	EAS	2,379	5,016	6.3	6.3	12.4	10.8	1.3	6.8	6.0	4.7		
Great Plains Energy	GXP	1,225	2,824	6.3	6.3	10.5	9.6	1.6	4.7	4.0	8.4		
IDACORP, Inc.	IDA	952	2,210	6.6	6.6	17.3	11.0	1.1	8.0	8.0	7.3		
NSTAR	NST	2,241	4,792	7.1	7.1	12.6	11.7	1.8	6.4	7.0	5.0		
Pinnacle West Capital Corporation	PNW	2,803	6,206	5.5	5.5	8.8	8.3	1.1	6.6	6.0	4.8		
Vectren Corp	VVC	1,573	2,840	8.7	8.7	12.9	11.7	1.8	7.7	7.0	4.6		
Mean				6.8	6.8	12.2	10.5	1.6	6.8	6.4	5.7		
Median				6.6	6.6	12.4	10.8	1.6	6.8	7.0	5.0		

SOURCE: SEC Filings

NOTES:

1. As of 08/01/02
2. I/B/E/S estimate as of 8/01/02
3. FirstCall estimate as of 8/01/02



COMPARABLE CREDIT ANALYSIS

Company Name	Capitalization ¹				Credit Ratings ⁵							
	Equity		Pfd Stock		Long Term		LTM	Long Term		Moody's		S&P Business Position ⁴
	Book Value (\$mm)	Book Value (\$mm)	Long Term Debt ² (\$mm)	Book Cap (\$mm)	Debt ³ /Book Cap ^{1,3} (%)	EBITDA/Interest (x)	Debt ³ /LTM EBITDA (x)	S&P Senior Unsecured	Senior Unsecured			
DPL Inc.	838	315	2,147	3,300	75	4.7	3.7	BBB	Baa1		6	
Energy East	1,891	388	2,288	4,567	59	3.7	3.3	BBB	Baa2		3	
Great Plains Energy	756	189	1,003	1,948	61	4.5	2.7	BBB	Baa2		6	
IDACORP, Inc.	882	104	791	1,777	50	4.8	2.7	BBB+	Baa1		5	
NSTAR	1,263	43	1,692	2,998	58	3.8	2.6	A-	A2		3	
Pinnacle West Capital Corporation	2,549	0	3,265	5,814	56	nmf ⁶	2.9	BBB	Baa2		5	
Vectren Corp	875	0	1,014	1,889	54	4.1	3.1	A-	A2		4	
Mean					59	4.3	3.0				5	
Median					58	4.3	2.9				5	

SOURCE: SEC Filings

NOTES:

1. As of 3/31/02
2. Includes long-term debt, minority interests and capital leases
3. Long-term debt includes preferred stock in addition to long-term debt, minority interests and capital leases
4. Standard & Poor's *Utilities & Perspectives* dated July 22, 2002
5. Credit ratings are for senior unsecured debt at the holding company unless otherwise noted
6. Pinnacle West Capital Corporation's LTM EBITDA/Interest coverage ratio is not meaningful in the context of this analysis due to high LTM interest capitalization